

FINANCIAL MANAGEMENT/Reserves are essential to fiscal health

John Incorvaia

American City & County, Jan 1, 2003

A municipality's fiscal policies should include a plan for maintaining reserves. Operating reserves (or fund balance) are a prudent fiscal management tool and an important credit factor in the analysis of financial flexibility.

The accumulation of reserves in favorable economic times could be a resource to sustain communities in a downturn. During recessions, municipal budgets can be hurt by declines in economically sensitive revenues (e.g., sales taxes, interest income and bed taxes) and cuts in state revenue sharing funds. Unpredictable events — such as hurricanes, earthquakes and floods — also can drain budgets.

The practice of maintaining adequate reserves has several internal and external benefits. Internally, reserves can supply funds to leverage state or federal grants; compensate for unexpected events; and provide cash flow until major revenues are received, thereby reducing or eliminating the need for cash-flow borrowing. Externally, investors, rating agencies and banks tend to view reserves favorably, thus improving a municipality's rating and its chances for receiving lines of credit.

Administrators sometimes struggle to determine the reserve amount that would be accepted universally by investors, residents, rating agencies and governing officials. The level of reserves should be predicated on items such as cyclical vulnerability of revenue streams, likelihood of natural disasters and volatility of expenditure items (e.g., social services and health care). When formulating reserve levels, cities also should consider the level of budgetary fixed costs, the amount of non-voted debt supported by traditional operating funds, historical delays in adoption of state budgets, proximity to operating limits, other statutory limitations on revenues and timing on reception of major revenue sources.

To formulate reserve levels, cities can choose to allocate enough money to cover a specific number of days of operating expenses, or they can allocate a flat percentage of operating revenues. In the former case, a minimum of one to two months of operating expenses should be considered, and in the latter instance, a minimum level of five percent

to 10 percent should be targeted.

Municipalities need to consider whether to govern their reserves through formal policy (ordinance, inclusion in local charters) or through targeted levels. Most lending institutions tend to favor formal reserve policies because they minimize political considerations of adequate reserve levels. Some lending institutions are comfortable relying on a municipality's long-term adherence to more informal policies, or targets, but informal policies have been associated with uneven long-term financial performance.

Sometimes, targets or policies are predicated on total balances that include questionable items such as reserves for encumbrances, inventories and subsequent years' expenditures, while undesignated balances tend to be narrow and fluctuate wildly. Additionally, operating reserves sometimes include receivables and accrued items, which tend to represent fund balance inaccurately.

Lending institutions consider the amount of available cash in the composition of fund balances and how much of that actually falls to the unreserved/undesignated portion of fund balance. The more cash in the fund balance, the more liquid the balance, and the more operating flexibility the municipality has.

Whether reserves are set aside in the form of rainy day funds, stabilization funds or undesignated balances, they are an important part of a municipality's fiscal health.

The author is senior vice president of New York-based Moody's Investors Service.

© 2003, PRIMEDIA Business Magazines & Media Inc. All rights reserved. This article is protected by United States copyright and other intellectual property laws and may not be reproduced, rewritten, distributed, disseminated, transmitted, displayed, published or broadcast, directly or indirectly, in any medium without the prior written permission of PRIMEDIA Business Corp.

Permission granted December 17, 2003 for limited distribution of this article as follows:

Dear Mr. King,

You are welcome to distribute copies of the article "FINANCIAL MANAGEMENT/Reserves are essential to fiscal health," by John Incorvaia, published in American City & County, Jan 1, 2003 to your county's public works staff and county commissioners. Please be sure to include credit to American City & County. Thank you for your interest,

Lindsay Isaacs
Managing Editor
American City & County
6151 Powers Ferry Road NW, Suite 200
Atlanta, GA 30339-2941
(770) 618-0199
(770) 618-0349 (fax)
lisaacs@primediabusiness.com
www.americancityandcounty.com